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Foreign Commercial Borrowing by the Indonesian Government– Issues and Institutions

By

Lex Rieffel

Prepared for
Agency for Fiscal Analysis
Ministry of Finance
Indonesia

Partnership for Economic Growth (PEG) Project*

April 30, 2003

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1. Assessment of Commercial Borrowing Options

Overview

A well-designed commercial borrowing program could: (a) mitigate the fiscal impact of resuming payments to Paris Club and London Club creditors in 2004-2005; (b) reduce the interest cost of servicing the central government's debt; (c) ease repayment of the $400 million Yankee bond that matures in 2006; (d) phase in "market discipline" as IMF discipline is phased out; (e) provide a benchmark that would facilitate foreign borrowing by Indonesian corporations ready to expand their business; and (f) "advertise" improvement in Indonesia's economic prospects.

A "sweet spot" in the bond market appears to exist for Indonesia, but is unlikely to remain at the end of 2003. A first step toward tapping the market would be to develop a clear vision of the objectives and parameters of a 2-3 year commercial borrowing program. A program for $2 billion from mid-2003 to mid-2005 might have more credibility than a smaller program. Awarding a mandate for a new bond issue early in the third quarter of 2003 could have a positive impact on market sentiment. A no-issue road show in the third quarter may be the best way to assess the potential for an initial bond issue in 2003. Issuing in the first half of 2004 would be difficult due to the elections. In the context of a strategy for self-reliance, borrowing from commercial sources has the advantage of not requiring policy conditionality, but the terms of such borrowing would only be favorable as long as creditors continue to believe that that Indonesia will maintain sound macropolicies and undertake essential structural reforms.

Pricing could be particularly favorable for a "plain vanilla" 10-year bond, like the 2006 Yankee issue. A 2-tranche (5 and 10 years) issue could be well received. Two benchmarks for a GOI issue are the Philippines and Bank Mandiri, at 500bp and 450bp over 10-year and 5-year US Treasury bonds, respectively. Hard to say whether a new GOI bond would price above Philippines or below Mandiri. A World Bank or ADB guarantee would not be welcomed by the market, would reduce liquidity, and impair the issue as an indicator of evolving country risk and therefore provide a weak benchmark for Indonesian corporate issuers. Securitization would be inconsistent with Indonesia's record of strong macro performance.

An equivalent amount of borrowing could be done with commercial banks in the form of syndicated loans, possibly at lower equivalent spread but with tenors limited to 5 years. However, outstanding London Club debt will depress demand and raise the price. Prepayment of London Club debt—possibly through an exchange for new loans or bonds—could have a substantial positive impact on both bond and bank loan pricing. A derivatives transaction (swapping Indonesian government bond interest for US government bond interest) might also be beneficial from a debt management perspective.

General Market View of Indonesia

Market sentiment on Indonesia's economic prospects is mixed. A small group sees steadily improving prospects. A larger group is wary, especially because of uncertainty related to the 2004 elections. All are impressed by Indonesia's macroeconomic performance, but concerned about the well-known structural weaknesses. A deeper concern is that the gains from sound macropolicies will be exhausted in the near term, which could means that growth falters and political instability returns.

The views of “buy side” market participants (fund managers, insurance companies, and other institutional investors) diverge systematically from those of “sell side” participants (bankers who syndicate loans and lead manage bond issues). The sell side emphasizes the positive aspects of Indonesia’s prospects (implying lower spreads) and the buy side emphasizes the negative aspects (implying higher spreads). The views will remain divergent until a deal is closed.

Standard & Poors assigns Indonesia a sovereign rating of CCC+; Moody’s assigns it a B3. Both of these ratings are close to the bottom of the rating scales. The OECD countries have placed Indonesia in Category 6 out of 7 risk categories for export credit insurance purposes (Philippines is in Category 4). These ratings generally follow market sentiment. A successful deal could lead to earlier upgrades that would benefit Indonesian borrowers generally.

Many market participants believe it is too soon for Indonesia to graduate from the IMF and Paris Club/London Club debt relief. A smaller number favor graduation at the end of 2003. Without graduating from debt relief, new commercial borrowing on favorable terms will not be possible.

<u>Market Appetite for GOI Debt</u>

The global market is exceptionally liquid now, especially for Asian bonds. Favorable technical factors include the delays in anticipated new Asian issues and above-average liquidity in the global corporate sector. Strong demand is reflected in the success of the recent Bank Mandiri issue. This “sweet spot” may not last much longer. Elections would make bond issuance difficult in the first half of 2004. A less risky strategy would be to build appetite through well-planned road shows over the next year to prepare for major issue in the second half of 2004. Preparing the DPR and the public for issuance could also take time.

The market could easily absorb $0.5 - $1.0 billion of GOI borrowing between now and the end of 2004. Twice this amount may not be more difficult.

<u>Borrowing from Banks vs. Issuing Bonds</u>

Banks are more receptive now than last year. Syndicated loans could price more favorably than bonds, but tenors beyond 5 years would be difficult. European banks are least interested, US banks skeptical, Asian banks eager. Swapping GOI bond interest for US Treasury bond interest could yield an obligation of Libor plus 1-2 percent. Pre-paying London Club debt could have a positive impact on market sentiment. London Club debt could also be exchanged for new bank debt with exit/entrance options.

The unmet demand for Asian bonds, including demand within Indonesia, is large. A program that includes borrowing in the form of both bonds and bank loans, depending on market conditions, could be advantageous. Philippines has program of this kind.

Features of New Bond Issues

The obvious tenor is 10 years. The obvious form is a Section 144A issue in the US targeting institutional investors. This would be "plain vanilla." Anything else would raise questions about the government's borrowing strategy. A two-tranche (5-10) issue could be well received. A two-tranche issue smaller than $0.5 billion would not have the desired degree of liquidity. A two-tranche $1.0 billion issue would not be too large.

Philippines government bonds and the recent Bank Mandiri issue provide the closest pricing benchmarks for a new GOI issue: 500bp (10 years) and 450bp (5 years) over US Treasuries, respectively. But there are technical arguments for pricing a new issue either above the Philippines or below Bank Mandiri. The lowest spread mentioned was 350bp, which would mean a total yield (coupon interest) at offer of 7.4%. (The 10-year Treasury yield was 3.90 on April 23.)

Neither a World Bank/ADB nor securitization would be welcomed by the market. A World Bank/ADB guarantee might reduce the spread to around 150bp over US Treasuries, but there is little market appetite for such guarantees and the result could be a spread in the 250-300bp range. (Information on the World Bank and ADB guarantee programs is provided in Annex A and B.) A World Bank guarantee limited narrowly to breach-of-contract risk for a large project loan (to finance power sector investment) could be helpful in mobilizing commercial financing on favorable terms (that would help slow down the rise in electricity rates) without shifting the burden of default by a private sector operator onto the government.

New GOI bonds would presumably include "collective action clauses." Mexico's introduction of these clauses in March has reversed the presumption. Instead of being able to extract some quid pro quo for including these clauses, Indonesia would have to make a strong case for not including them.

Contingency Financing

One disadvantage of commercial financing (especially relative to official financing) is that it tends to be pro-cyclical: it is easy to obtain when a country is in a strong B/P position and difficult to obtain when a country is in a weak B/P position. As a result, a country that is beginning to borrow commercially is well advised to line up some contingency financing in the event that market conditions turn sour (and the cost of commercial borrowing becomes very expensive) due to some kind of shock such as the Bali bombing, the war in Iraq, or SARS. A shock that had an impact on the budget of 1-1.5 percent of GDP would create a $2-3 billion financing gap.

While contingency financing from commercial sources is available in theory, it is extremely difficult to arrange in practice. Banks are the only source and they could only commit to making money available at some point in the next 1-3 years at a fixed interest rate or spread by pre-funding the amount (borrowing it themselves and sitting on it until Indonesia needs it). The fees required to overcome this reluctance would be substantial.

Indonesia could activate swap lines established in the ASEAN+3 context, but these are for short-term B/P financing not budget financing. The most obvious sources of long-term contingency financing are the World Bank, the ADB, and Japan (China and Saudi Arabia are less obvious choices). Each of these has practical limits on what it could contribute on short notice, perhaps around $1 billion, and it is hard to imagine circumstances that would make combined financing from all three greater than $3 billion feasible. Each of these partners would look for a distinct set of conditionalities. In consultations with these partners, Indonesia may be able to obtain broad agreement on a joint contingency arrangement for 2004-5 that would enable Indonesia to avoid going back to the IMF and the Paris Club without adding significantly to the policy commitments contained in the Repeta/MTPF for 2004-2006 and the budget for 2004.

Attachment A

World Bank Guarantees

Background

- The guarantee instrument was "mainstreamed" in 1994, meaning that it was given the status of a normal instrument rather than an instrument to be used in exceptional cases.

- When the World Bank was established in the 1940s, it was expected that most World Bank operations would be in the form of guarantees of commercial bank financing, but the Bank quickly moved into the mode of direct lending of funds raised through issuing bonds. This technique allowed the Bank to lend to all borrowing countries at the same interest rate and at a better rate than available with guarantees. As a result, almost no guarantees were issued between 1950 and 1990.

- Interest in guarantees picked up around 1990 when World Bank borrowers became more interested in access to international capital markets. The policy on mainstreaming was adopted after several experimental operations.

- The number of guarantee operations since 1994 has been small, and the experience a bit unsettling. In particular, there have been problems with two power projects in Pakistan, one power project in Cote d'Ivoire, and a banking sector reform operation in Argentina that were among the largest and highest profile guarantees. A major problem with the program from the private sector perspective has been pricing (guarantees have been priced the same as loans). Two problems from the perspective of the borrowing countries have been the requirement of a host-country counter-guarantee for private sector projects and the practice of counting guarantees against country lending limits.

The Program

- Under the mainstreaming program, the Bank offers three kinds of guarantees:

  --Partial credit guarantees, where the Bank bears the credit risk of only a small portion of the project loan.

  --Partial risk guarantees, where the Bank bears only certain specified project risks (e.g., changes in electricity tariffs inconsistent with the terms of the IPP contract).

  --Policy-based guarantees (recently added), where the commercial borrowing is in support of a broad sector adjustment program rather than a specific project.

The Portfolio

- Most guarantees have been for power projects: 3 in China (1994-95), 2 in Pakistan (1995-96), 1 each in Philippines (1994), Thailand (1998), Bangladesh (2001), Lebanon (1997), Morocco (1997), and Cote d'Ivoire (1998). The largest of these was the Thai project at $300 million. The only others over $100 million were the first Pakistan project ($240 million) and the Morocco project ($176 million).

- The only other project guarantees completed so far include a highway project for Hungary (1990), a telecommunications project for Jordan (1995), and a satellite launching project jointly by Russia and Ukraine (1997).

- Only two policy-based guarantees have been completed. In 1999, Argentina obtained a guarantee for $250 million of a $1,500 million bond issue related to strengthening the banking system. (The guarantee was called when Argentina defaulted at the end of 2001). In 2001, Colombia obtained a guarantee for $119 million of a $750 million bond issue.

- The World Bank web site lists seven pending guarantees: power projects in Vietnam, Laos, and Uganda; a natural gas project in Mozambique; a gas pipeline project in Brazil, a water project in Jordan, and a regional capital market project for West Africa.

The Electricity Generating Authority of Thailand (EGAT) Project

- Approved: September 1998. Closed October 1998.
- Amount of guarantee approved: $0.6 billion (two $300 million tranches)
- Purpose: Finance 4 generating projects and 4 transmission systems. To support the restructuring, corporatization, and privatization of EGAT.

- Total Project Costs: $4.9 billion ($2.5 billion financed by supplier credits, $0.9 billion by IBRD loan, $0.8 billion by Thai government, $0.6 billion by international bonds)

- Estimated terms of bond financing from appraisal report (assuming GOT counter-guarantee in both cases):
  --400bp over US Treasuries for 5-year bonds without World Bank guarantee
  --150bp over US Treasuries for 10-year bonds with World Bank guarantee

- Actual terms of financing:
  --285bp over US Treasuries (10-year tenor)
  --Non-accelerable guarantee of principal plus rolling guarantee of one interest payment (GOT providing general guarantee of interest payments)
  --20bp management and underwriting fee plus 35bp selling fee
  --Rated A- by S&P, three notches above Thai government rating

Attachment B

Asian Development Bank Guarantees

Background

Shortly after the World Bank made guarantees a "mainstream" instrument in 1994, the ADB introduced a similar guarantee program. The deal flow since then has been just as disappointing. The ADB did not follow the World Bank and add a "policy based" product. Unlike the World Bank, the ADB can issue guarantees without a host-government counter-guarantee, but the World Bank's private sector affiliate (the IFC) can provide such guarantees (although it has shied away from this business).

The Program

Unlike the World Bank program, the ADB only guarantees commercial financing for a project to which it is also making a direct loan as an "anchor." There is no financing limit for public-sector projects or projects counter-guaranteed by the host government.

Partial Credit Guarantee. For private sector projects, the ADB's exposure is limited to $75 million, including both its direct loan and the guaranteed commercial financing.

Political Risk Guarantee. For private sector projects, the ADB's exposure is limited to $150 million, including both its direct loan and the guaranteed commercial financing. The ADB will cover any combination of the following risks: inconvertibility, expropriation, political violence, government breach of contract. The product is designed to be easily used in combination with a guarantee from the World Bank's investment insurance affiliate (MIGA).

The Portfolio

Five projects, two in the power sector, three that are forms of private sector financing facilities. Two projects in Sri Lanka, the others in Pakistan, Philippines and Thailand.

Northern Luzon Transmission and Generation (Philippines, 1995). Borrower = National Power Corporation. Partial credit guarantee for $140 million; ADB direct loan for $240 million; other financing from Jexim, World Bank, KfW and National Power Corporation. Total project cost = $900 million. 20-year syndicated loan from 9 banks. ADB guaranteed principal. GOP guaranteed interest.

Export Financing Facility (Thailand, 1998). Borrower = Export-Import Bank of Thailand. Partial credit guarantee for $950 million; ADB direct loan for $50 million. Total project cost = $1,000 million. 5-year syndicated loan from 68 banks. ADB guaranteed principal and interest in first three years.

Private Sector Power Generation (Sri Lanka, 2000). Borrower = AES Kelanitissa Corporation. Partial risk guarantee for $50 million; ADB direct loan for $25 million; other private for $25 million. Total project cost = $100 million. Syndicated loan for 12 years pending. Guaranteed for breach of contract, expropriation, and inconvertibility.

Small/Medium Enterprise Trade Finance (Pakistan, 2001). Borrower = Pakistan Export Finance Guarantee Agency (PEFGA). Partial risk guarantee for $150 million; ADB direct loan for $150 million; ADB equity in PEFGA for $2 million. Total project cost = $300 million. Revolving lines of credit from consortium of international banks open for 6 years; generally for 360-day trade financing. Guaranteed for inconvertibility and other specified political risks.

Small/Medium Enterprise Financing (Sri Lanka, 2001). Borrower = DFCC Bank. Partial credit guarantee for $65 million; ADB direct loan for $5 million. Total project cost = $70 million. Syndicated loan for 10 years. ADB guaranteed principal. GOSL guaranteed interest.

Achieving Policy Credibility Post-2003:
Rough Outline of Process and Content

I. The Policy Challenge

A. Overview

1. National goals
   --GDP growth, employment, alleviate poverty, improve health, etc.

2. A strategy for self-reliance in 2004-2006
   --Economic stability in election year; solid foundation for next government.
   --Resilience: improving capacity to adjust policies; encouraging private sector job creation by removing impediments to investment.
   --Continue fiscal consolidation; reduce central government debt/GDP ratio to below 40 percent (issue of regional government debt).
   --End dependence on exceptional financing (IMF, Paris/London Club, program loans).

3. Benefits of policy credibility
   --Self-confidence (internally).
   --Confidence of official institutions (IMF, World Bank, ADB, bilateral donors).
   --Market confidence (private investors).
   --The costs of losing credibility.

B. Elements of a Credible Policy Framework

1. Setting targets
   --Appropriate targets: performance the government can control.
   --Time frame (medium-term framework, annual program, quarterly benchmarks)
   --Macroeconomic (growth, inflation, external balance, fiscal, monetary).
   --Structural (legal, regulatory, institutional changes relating to sector objectives: security, regional autonomy, poverty, environment, education, etc.).

2. Monitoring performance
   -- Robust internal monitoring implies less intrusive external monitoring.
   --Internal monitoring (responsible agencies, BPK, parliament).
   --External monitoring (IMF, CGI, international capital markets).

3. Enforcement
   --By the cabinet (peer pressure, budget accountability).
   --By the DPR (oversight, legislation).

4. Essential aspects of policy credibility
   --Clarity about policy agenda and policy measures.
   --Coherence in implementing the program (all rowing in same direction).
   --Consistency over time (no sudden unjustified changes in direction).

II. Options for Reinforcing Policy Credibility Post-2003

A. EFF Arrangement and More Debt Relief

Features: Three-year time frame. No reduction in stock of debt owed to IMF. Quarterly letters of intent, staff reviews, Board discussions, reports published. Paris Club relief possible (principal only). London Club relief (required by Paris Club).

Implications: Mixed message due to "prolonged use" of IMF credit and more debt relief. Puts pressure on MDBs to desirable program lending. Debt relief reduces budget strain, but constrains bilateral aid commitments. No rating upgrade or new commercial borrowing. Committing new government to IMF monitoring could be election issue.

B. No-Money Stand-by Arrangement

Features: One- or two-year time frame. Reduces IMF debt. Quarterly letters of intent, staff reviews, Board discussions, reports published. Paris Club relief unlikely.

Implications: Reinforces policy credibility. CGI donors more likely to increase program loans. Most favorable for rating upgrade and new commercial borrowing. Creates large fiscal shock. Large payment flow to IMF could become a campaign issue. New government committed to at most one quarter of IMF monitoring.

C. Post-Program Monitoring

Features: Continues until outstanding debt to IMF falls below 100 percent of quota (2007 or 2008). Same reduction in IMF debt as No-Money Stand-by. Program with macro and structural benchmarks required. No letters of intent. Semiannual reviews. Board discussions, staff reports published. Paris Club relief impossible.

Implications: Less credible. Same fiscal impact as No-Money Stand-by because full payment to Paris Club/London Club creditors resumes. IMF relations minimized as campaign issue because no drawings or letter of intent. But monitoring continues on semi-annual cycle. More conditionality set by CGI donors in context of program loans. Opens door for rating upgrade and new commercial borrowing.

D. Pre-Pay the IMF; Rely on Market Discipline

Features: Requires prepayment of $5-6 billion at year-end 2003, with corresponding drop in gross foreign exchange reserves. No program or letters of intent required. Annual Article IV consultations by staff. Paris Club relief impossible.

Implications: Little credibility without better performance than expected. Same fiscal impact as No-Money Stand-by because full payment to Paris Club/London Club creditors resumes. BOP shock of sharp drop in reserves likely to have adverse impact on donor and investor confidence. Totally removes IMF as a campaign issue. CGI donors likely to increase program lending that would be seen as mainly benefiting the IMF. Opens door for rating upgrade and new commercial borrowing, but country risk premium likely to increase substantially.

III. A Credible Process for Target-Setting, Monitoring, and Enforcement

A. Setting Targets

1. Medium-Term Policy Framework (MTPF with MTEF)

    --Policy Team formally established in a Keppres.
    --Draft MTPF/MTEF to Policy Team in Jan-Feb.
    --Consultations with DPR, IMF, CGI.
    --Draft MTPF/MTEF to cabinet with budget in June.
    --MTPF/MTEF to DPR in August with budget.
    --MTPF/MTEF adopted with passage of budget by DPR in October/November.

2. Annual Programs

    --Draft annual program to Policy Team in September/October.
    --Consultations with DPR, IMF, CGI.
    --Draft annual program to cabinet after passage of budget by DPR.
    --Annual program announced in November/December.

B. Monitoring

--Draft Action Plan (addressing performance against structural as well as economic targets) to Policy Team two weeks after end of quarter.
--Consultations with DPR, IMF, CGI, as appropriate.
--Draft Action Plan to cabinet 4 weeks after end of quarter.
--Action Plan announced 6 weeks after end of quarter.

C. Enforcement

--Agency responsible for achieving each benchmark clearly identified at outset.
--Failure to meet performance benchmark triggers automatic review by Policy Team. --Policy Team agrees on action to be included in next Action Plan.
--DPR, IMF, CGI, as appropriate, notified within two weeks of missing target.
--Formal cabinet discussion of any slippage and approval of recommended action.

IV. A Credible Policy Framework for 2004-2006

A. Medium-Term Framework

--Main theme for policy agenda (e.g., greater self-reliance).

--Medium-term fiscal/monetary objectives and structural objectives.

B. Annual Program

--Quantitative quarterly targets for monetary policy, fiscal policy, etc.

--Time-bound structural benchmarks.

ANNEX A

Draft Framework for 2004-2006

1. Recent Progress and Broad Objectives
   --Major structural and macro accomplishments in past year.
   --Main theme for 2004 (e.g., restoring creditworthiness by ending dependence on debt relief).
   --Broad macro and structural objectives (growth, inflation, etc.).

1. Macroeconomic Policies

   a. Monetary policy
      --Broad range for base money growth.

   b. Fiscal policy
      --Broad deficit, revenue, expenditure goals.
      --Specific measures to bolster revenues, reduce subsidies, strengthen expenditure management, and improve debt management.
      --Measures to improve fiscal decentralization.
      --Measures to improve fiscal transparency and public sector governance.

   c. Balance of payments and external policies
      --Broad range for gross reserves, C/A deficit, etc.

2. Structural Reforms

   a. Financial sector
      --Bank divestment and restructuring
      --Financial sector safety net
      --Bank Indonesia

   b. Government administrative reform
      -- IBRA, JITF, state enterprises

   c. Legal and judicial reform
      --Commercial court, judicial commission, KPKPN, bankruptcy law

   d. Labor policies
      --Labor legislation, minimum wage policy

   e. Improving security

   f. etc.

ANNEX B

Draft Annual Program for 2004

1. Macroeconomic Policies

   a. Monetary policy
      --Net domestic assets
      --Base money

   b. Fiscal policy
      -- Central government balance

   c. Balance of payments and external policies
      --Net international reserves
      --Stock of short-term debt
      --External non-concessional debt limit
      --Non-accumulation of arrears

2. Structural Policies

   a. Macroeconomic stability
      --Staged elimination of non-targeted fuel subsidies
      --Policy agendas for tax administration, customs administration, treasury operations, Inspector General operations
      --Review of tax system to improve competitiveness

   b. Complete financial sector restructuring; public sector governance reforms
      --Banking sector reform
      --Corporate restructuring, legislation and governance
      --SOE reform and privatization

   d. Improve the investment climate

   e. --to be determined